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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1984

AWECO, INC. and
UNITED-AMERICAN CAR CO.,
Petitioners,

v.

UNITED STATES OF AMERICA,
Respondent.

REPLY BRIEF IN SUPPORT OF PETITION FOR CERTIORARI

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TABLE OF CONTENTS

	Page
TABLE OF CONTENTS	i
TABLE OF AUTHORITIES	ii
ARGUMENT	1
I. THE LEGAL ISSUE PRESENTED BY THIS CASE IS RIPE FOR DETERMINATION	1
II. CONGRESS DID NOT INTEND THAT THE ABSOLUTE PRIORITY RULE APPLY TO PRECONFIRMATION COMPROMISES IN CASES UNDER CHAPTER 11	3
III. THE DECISION OF THE FIFTH CIRCUIT CONFLICTS WITH APPLICABLE DECISIONS OF THIS COURT AND OF THE EIGHTH CIRCUIT	7
CONCLUSION	10
CERTIFICATE OF SERVICE	11

TABLE OF AUTHORITIES

CASES

	Page
Drexel v. Loomis, 35 F.2d 800 (8th Cir. 1929)	7, 8, 9
Flight Transportation Corp. Securities Litigation, In re, 730 F.2d 1128 (8th Cir. 1984)	2, 3, 7, 9, 10
Hutto v. Davis, 454 U.S. 370 (1982)	2
Oceanside Properties, Inc., In re, 14 Bankr. 95 (Bankr. D. Hawaii 1981)	8
Protective Committee v. Anderson, 390 U.S. 414 (1968)	2, 3, 7, 8, 9
Salem Mortgage Co., In re, 34 Bankr. 902 (Bankr. E.D. Mich. 1983)	8
Sherman Homes, Inc., In re, 28 Bankr. 176 (Bankr. D. Me. 1983)	8
Washington v. Watkins, 655 F.2d 1346 (5th Cir. 1981), *cert. denied*, 456 U.S. 949 (1982)	3

STATUTES AND RULES

Bankruptcy Act of 1898, as amended, 11 U.S.C. §§ 1-1103 (1976) (repealed effective Oct. 1, 1979)	2, 4
Bankruptcy Reform Act of 1978, 11 U.S.C. §§ 101-15326 (1982), *amended by* Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333 (1984)	passim
11 U.S.C. §§ 361-64 (1982)	6
11 U.S.C. § 1129(a) (1982)	4
11 U.S.C. § 1129(b) (1982)	4, 5, 6
28 U.S.C. § 1254(1) (1982)	2

Bankr. R. 919 (superseded) 4
Bankr. R. 9019 ..... 4, 5, 6

OTHER AUTHORITIES

H.R. Rep. No. 595, 95th Cong., 1st Sess. (1977), *reprinted in*, 1978 U.S. Code Cong. & Ad. News 5963 4
124 Cong. Rec. H 11,104 (daily ed. Sept. 28, 1978) 5
124 Cong. Rec. S 17,420 (daily ed. Oct. 6, 1978) 5

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Petitioners, AWECO, Inc. ("Aweco") and United-American Car Co. ("United") hereby file this reply brief in support of their petition for writ of certiorari.

ARGUMENT

I.

THE LEGAL ISSUE PRESENTED BY THIS CASE IS RIPE FOR DETERMINATION

The United States in its brief in opposition suggests that this Court ought not grant a writ of certiorari because the decision of the court of appeals is "interlocutory" and "does not preclude the possibility that [Aweco and United] may prevail on remand." Brief for

Respondent at 4.[1] Such a suggestion is without merit as it ignores the direct conflict between the holding of the Fifth Circuit in this case and the Eighth Circuit in *In re Flight Transportation Corp. Securities Litigation*, 730 F.2d 1128 (8th Cir. 1984); the mandate of *Protective Committee v. Anderson*, 390 U.S. 414 (1968); and Congress' manifest intent in the Bankruptcy Reform Act of 1978 (the "Bankruptcy Code").[2]

At issue in this case is the application of the absolute priority rule developed under Chapter X of the repealed Bankruptcy Act of 1898 (the "Bankruptcy Act")[3] to a preconfirmation compromise and settlement of a claim made in a bankruptcy case arising under Chapter 11 of the Bankruptcy Code. Aweco, as debtor, and United, as creditor, urge in their petition for writ of certiorari that the court of appeals erred in its "extension" of the absolute priority rule to such a compromise and settlement in the face of Congressional policy set forth in the new Bankruptcy Code. This Court should grant a writ of certiorari and reverse the judgment of the court of appeals to prevent any continuing precedential effect of the lower court's opinion. Until modified by this Court, the opinion of the Fifth Circuit will erroneously bind other panels of that court and the district and bankruptcy courts in that circuit, *cf. Hutto v. Davis*, 454 U.S. 370, 375 (1982) (precedent of higher federal court "must be fol-

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[1] The United States does not dispute that United and Aweco properly have invoked the jurisdiction of this Court under 28 U.S.C. § 1254(1) (1982).

[2] Bankruptcy Reform Act of 1978, 11 U.S.C. §§ 101-15326 (1982), *amended by* Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333 (1984).

[3] Bankruptcy Act of 1898, as amended, 11 U.S.C. §§ 1-1103 (1976) (repealed effective Oct. 1, 1979).

lowed by the lower federal courts no matter how misguided the judges of those courts may think it to be"), when all trial courts are entitled to have the proper legal standard enunciated. *See also Washington v. Watkins*, 655 F.2d 1346, 1354 n.10 (5th Cir. 1981), *cert. denied*, 456 U.S. 949 (1982). Moreover, even outside of the Fifth Circuit great deference can be expected to be shown to the opinion of the court of appeals notwithstanding this Court's prior holding in *Protective Committee v. Anderson*, 390 U.S. 414 (1968), and the opinion of the Eighth Circuit in *In re Flight Transportation Corp. Securities Litigation*, 730 F.2d 1128 (8th Cir. 1984).

Accordingly, this Court should recognize the legal issue presented in this case to be ripe for determination and should grant the writ of certiorari to establish as a matter of law the correct standard for approval of compromises and settlements under the Bankruptcy Code, the application of *Protective Committee* under that statute, and to avoid the manifest injustice of remand of this case with instructions to reconsider the compromise based upon the Fifth Circuit's improper standard.

II.

CONGRESS DID NOT INTEND THAT THE ABSOLUTE PRIORITY RULE APPLY TO PRECONFIRMATION COMPROMISES IN CASES UNDER CHAPTER 11

The United States argues that the court of appeals properly applied the absolute priority rule to the preconfirmation compromise and settlement in this case to permit the United States "to block [the] settlement of junior claims." Brief for Respondent at 4-7, 9-

10. That argument is without support under applicable law[4] and is contrary to Congress' intent that the fair and equitable standard and the absolute priority rule that is its corollary have only a limited application in reorganization cases brought under the Bankruptcy Code.

One of the principal purposes of Congress in enacting Chapter 11 of the Bankruptcy Code was to limit severely application of the absolute priority rule and the difficulties and abuses it had generated under repealed Chapter X of the Bankruptcy Act. *See, e.g.*, H.R. Rep. No. 595, 95th Cong., 1st Sess. at 221-24 (1977), *reprinted in*, 1978 U.S. Code Cong. & Ad. News 5963. Thus, under the new Bankruptcy Code the fair and equitable standard, including the absolute priority rule, applies only to confirmations of plans of reorganization under section 1129(b).[5] The "limited extension" of the absolute priority rule by the Fifth Circuit defeats the intent of Congress.

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[4] The court of appeals in its opinion and the United States in its brief *cite no case* in which the fair and equitable standard and the absolute priority rule have been applied to compromise and settlement agreements outside of a plan of reorganization. *See* Petition for Certiorari at 19 n.28. *See also infra* at 8.

[5] The fair and equitable standard and the absolute priority rule do not apply to the confirmation of all plans of reorganization in cases under Chapter 11. *See* 11 U.S.C. § 1129(a) (1982) (permitting confirmation of plans of reorganization without regard to the absolute priority rule). Similarly, neither former Bankruptcy Rule 919 nor current Bankruptcy Rule 9019, which deal with preconfirmation compromises and settlements, contain any reference to the fair and equitable standard or the absolute priority rule. *Compare* Bankr. R. 919 (superseded) *and* Bankr. R. 9019 *with* 11 U.S.C. § 1129(b)(1) (1982).

Section 1129(b) of the Bankruptcy Code, 11 U.S.C. § 1129(b) (1982), is a device that may be used *solely* by a plan proponent[6] to achieve confirmation of a plan of reorganization. That section, and the fair and equitable standard and absolute priority rule contained therein, apply only in the event that the proponent of a plan of reorganization seeks confirmation of that plan when one or more classes of creditors fails to accept the plan of reorganization. *The fair and equitable standard and the absolute priority rule have no other application in cases under Chapter 11 and, in particular, do not apply to preconfirmation compromise and settlement agreements approved under Rule 9019.*

The United States contends that Aweco's and United's position on the limited application of the absolute priority rule is "at odds with common sense," claiming that under petitioners' interpretation of the Bankruptcy Code "a debtor could deliberately postpone formulation of a plan, submit settlements of selected junior claims for approval, and exhaust the estate's assets by distributions to those junior creditors before a plan of reorganization was even proposed." Brief for Respondent at 6. That contention is wholly without merit as it fails to consider the specific protections afforded to senior creditors under the Bank-

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[6] There is no merit to the United States' argument that Congress intended that the fair and equitable standard be applied at the behest of objecting senior creditors. Brief for Respondent at 6. Rather, the legislative history makes clear that section 1129(b) was intended by Congress to be an "alternative confirmation standard, . . . called into play *only on the request of the proponent of the plan.*" 124 Cong. Rec. H 11,104 (daily ed. Sept. 28, 1978) (emphasis supplied); 124 Cong. Rec. S 17,420 (daily ed. Oct. 6, 1978) (emphasis supplied).

ruptcy Code other than application of the absolute priority rule.

All creditors have substantial protection against capricious actions by a debtor.[7] As in the instant case, notice will be given and hearing had concerning settlement of a dispute in a Chapter 11 case. *See* Bankr. R. 9019. An objecting creditor has a host of remedies to protect its position. For example, if it is a secured creditor as the Respondent here asserts, it may seek "adequate protection" of its interest. 11 U.S.C. §§ 361-64 (1982). Until a plan of reorganization is filed and reaches a hearing on confirmation, however, there is no provision in the Bankruptcy Code suggesting that the reference to the fair and equitable standard under the limited circumstances in section 1129(b) may be expanded to hinder a debtor in the administration of the case and the conduct of its business or that such standard must be applied by the bankruptcy court to any matter coming before it.

This Court should, therefore, grant the writ of certiorari and reverse the judgment of the court of appeals to prevent the frustration of Congress' intent.

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[7] Elsewhere in its brief the United States expressly acknowledges that "remedies may well be appropriate where a debtor is systematically distributing its assets pursuant to piecemeal settlements of junior claims. Brief for Respondent at 7 n.5. Notwithstanding the adequacy of those statutory remedies, the United States contends that no basis exists to deny additional protection to senior creditors through application of the absolute priority rule. With due respect, *the basis from which to deny application of the absolute priority rule in this case is Congress' intent that the rule be applied only to confirmations of plans of reorganization under section 1129(b).*

III.

THE DECISION OF THE FIFTH CIRCUIT CONFLICTS WITH APPLICABLE DECISIONS OF THIS COURT AND OF THE EIGHTH CIRCUIT

In the petition for certiorari Aweco and United contend that the decision of the court of appeals conflicts with the decision of this Court in *Protective Committee v. Anderson*, 390 U.S. 414 (1968) and with the recent decision of the Eighth Circuit in *In re Flight Transportation Corp. Securities Litigation*, 730 F.2d 1128 (8th Cir. 1984). The United States in its brief attempts unsuccessfully to dismiss out of hand the obvious conflict with *Protective Committee* and to distinguish *Flight Transportation*. Brief for Respondent at 6 n.3, 10. Those unsuccessful attempts are without merit.

In *Protective Committee* this Court stated that no determination could be made as to whether to approve a compromise and settlement agreement until

> the bankruptcy judge has apprised himself of all facts necessary for an intelligent and objective opinion of the probabilities of ultimate success should the claim be litigated. Further, the judge should form an educated estimate of the complexity, expense, and likely duration of such litigation, the possible difficulties of collecting on any judgment which might be obtained, and all other factors relevant to a full and fair assessment of the wisdom of the proposed compromise.

390 U.S. at 424. This standard is essentially the standard set out in *Drexel v. Loomis*, 35 F.2d 800, 806 (8th

Cir. 1929) and applied by other courts in cases under Chapter 11. *See, e.g., In re Salem Mortgage Co.*, 34 Bankr. 902, 909 (Bankr. E.D. Mich. 1983); *In re Sherman Homes, Inc.*, 28 Bankr. 176, 177 (Bankr. D. Me. 1983); *In re Oceanside Properties, Inc.*, 14 Bankr. 95, 99 (Bankr. D. Hawaii 1981). The orders of the bankruptcy court and the district court in this case explicitly and faithfully conform to that standard which was not given deference by the Fifth Circuit.

The United States totally ignores the pronouncement of that standard in *Protective Committee* and transplants the absolute priority rule applied to the plan of reorganization in *Protective Committee* to the preconfirmation compromise and settlement at issue in this Bankruptcy Code case. That argument fails to give effect to Congress' subsequently announced intent that the absolute priority rule have only limited application in cases under the new Chapter 11.[8] The argument rests solely upon its own weight, as neither the United States nor the court of appeals cites any case in which the fair and equitable standard and the absolute priority rule have been applied to a preconfirmation compromise and settlement. Lastly, the argument disregards entirely that the effect of the decision in *Protective Committee* was not to provide protection to senior creditors against compromise of junior debt but was to ensure that the then applicable standards relating to confirmation of Chapter X plans were complied

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[8] The United States fails to distinguish between the generally applicable fair and equitable test for approval of compromises under the *Drexel* standard and the absolute priority rule, which is often described as "fair and equitable" when used as a term of art. Prior to the Fifth Circuit's ruling, the absolute priority technical meaning of "fair and equitable" was never applied to a compromise and settlement.

with so that holders of junior interests were not improperly eliminated from participation in the reorganized debtor.

The attempt by the United States to distinguish the Eighth Circuit's decision in *Flight Transportation* is equally without merit as the factual circumstances in the cases are functionally identical and that case is in direct conflict with the Fifth Circuit. Both cases involve settlements outside of a plan of reorganization; both cases involve the receipt of funds by junior creditors before senior creditors are fully paid; and both cases involve objecting senior creditors. Notwithstanding these similarities, in *Flight Transportation* the Sharing Agreement was approved by the Eighth Circuit under the *Drexel* standard while in this case the Fifth Circuit disapproved the compromise and settlement after applying the absolute priority rule.[9]

The direct conflict between the decision of the Fifth Circuit in this case and the decision of the Eighth Circuit in *Flight Transportation* is further shown by a review of the briefs filed in *Flight Transportation.* There, certain of the objecting senior creditors, citing *Protective Committee*, argued in their brief that the Sharing Agreement violated the absolute priority rule by allowing junior claims to be paid before senior claims. *See* Brief of Appellants, Adams group, at 25-28, *In re Flight Transportation Corp. Securities Liti-*

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[9] Had the Eighth Circuit in *Flight Transportation* applied the absolute priority rule rather than the *Drexel* standard, the settlement at issue in that case could not have been approved because the *Flight Transportation* shareholders, as a junior class, were to receive funds that, had the constructive trust litigation been lost, would have been the property of the bankruptcy estate and available to satisfy the claims of senior creditors.

gation, 730 F.2d 1128 (8th Cir. 1984). The Eighth Circuit rejected that argument by concluding that the Sharing Agreement was a preconfirmation compromise rather than a plan of reorganization and, as such, was not subject to the absolute priority rule or other standards applicable to confirmation of plans. *See* 730 F.2d at 1134 & n.8.

IV.

CONCLUSION

For the foregoing reasons and for the reasons stated in their petition for certiorari, Aweco and United pray that this Court will grant the writ of certiorari and will reverse the judgment of the Fifth Circuit.

Respectfully submitted,

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CERTIFICATE OF SERVICE

This is to certify that the undersigned, a member of the Bar of this Court, has this day served a copy of the foregoing upon counsel for the Respondent United States of America by causing three copies of the same to be deposited in the United States mail, first-class postage prepaid, addressed as follows:

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